



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: 201503018
Release Date: 1/16/2015
Date: October 24, 2014

Contact Person:
Identification Number:
Telephone Number:
Employer Identification Number:

Uniform Issue List Number:

501.03-00
511.00-00
512.00-00
512.01-00
512.10-00

Legend:

B =
State X =
State Y =
Date x =
Year x1 =
Year x2 =
Year x3 =
Program A =
Software X =
x1 =

Dear :

We have considered your ruling request dated September 5, 2014. You have requested rulings relating to the tax consequences under §§501(c)(3) and 512 of the Internal Revenue Code stemming from your formation of B a wholly-owned for-profit subsidiary.

Facts:

You are a not-for-profit corporation organized under the laws of State X as of Year x1. You are recognized as an organization exempt under §501(c)(3) of the Code as an educational institution. You were formed in Year x2 as an accounting and secretarial school, and you have now evolved into a multi-disciplinary institution.

You offer degrees at the associate's, bachelor's, masters' and doctoral levels. You have

graduate and undergraduate programs in business, education, hospitality, community economic development and liberal arts. There are approximately x1 full and part-time students currently enrolled in various courses offered by you directly or through one of your divisions. Students can participate in traditional campus daytime programs or evening and weekend part-time and hybrid courses at your regional centers. You also offer all of your continuing education programs online.

You launched Program A as a division of you and not a separate entity to improve educational opportunities to working adults. Your financial activities are combined with that of Program A and are reported in your annual Form 990 information returns.

Program A is an online educational program that allows students to enroll in educational courses through a self-paced and self-directed model. This program differs from the traditional class setting where students are required to take a pre-defined number of courses to graduate. Before students can advance in Program A and obtain degrees they have to prove mastery in certain core competencies related to the degree. At the time of implementing Program A, there were no other universities offering degree programs based on this structure of competency-based learning. Since this competency-based learning program was unique to Program A, there was no existing computer architecture to run and track the program. Consequently, you developed Software X as your own proprietary software.

There have been other unaffiliated educational institutions also interested in offering competency-based programs that have inquired about licensing Software X from you. You are in the process of determining whether the licensing of Software X to other entities could be a viable commercial business. You formed B and it was incorporated in State Y on Date x to further develop Software X and license it to other educational institutions and commercial businesses. B currently does not have any employees or any activities.

You propose to contribute Software X to B while retaining a royalty-free license for use in your own operations. B would determine and charge a fair market value for the license of Software X to other unaffiliated organizations for use in creating their educational programs.

You will own 100% of the stock in B and will appoint all of its directors. The initial Board of Directors of B will consist of three members of your Board of Directors. You plan to expand the Board of Directors of B to include seven persons within six months of formation and prior to the commencement of any substantial activities. Pursuant to B's Bylaws a majority of the directors shall not be employed by you nor be on your Board of Directors or related to a person employed by, or on your Board. The president of B will not be either a person who is on your Board nor one of your employees.

All compensation that B pays to its directors, officers, employees, and agents for services rendered will be reasonable. Having a for-profit subsidiary such as B, you believe, will allow it to attract and retain key employees with an equity-based compensation system. Thus, any equity based compensation system for B's directors and employees will conform to those offered by comparable entities.

You will not actively participate in the day-to-day operations of B. B will also maintain separate facilities, addresses, telephone numbers, telephone listings, and bank accounts and other financial records. In the event that B does lease office space from you or receives administrative services from you, then B, as required by its Bylaws, will reimburse you for fair market value of such use. The dividends that you expect to receive from B will be an insignificant percentage of your total support.

Rulings Requested:

- 1) Your ownership of B will not have an adverse effect on your tax-exempt status under §501(c)(3) .
- 2) The gross income realized by B will not be treated as unrelated business taxable income to you under §512(a)(1).
- 3) The dividends that you may receive from B will be excluded under §512(b)(1) from the computation of unrelated business taxable income under §512(a)(1).

Law:

Section 501(c)(3) of the Code provides for exemption from federal income tax of organizations organized and operated "exclusively" for religious and other specified exempt purposes, "no part of the net earnings of which inures to the benefit of any private shareholder or individual," and which does not engage in substantial lobbying activities or proscribed political activities.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish such purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(1) of the Code provides, in part, that all dividends shall be excluded from the computation of unrelated business taxable income.

Section 512(b)(13) of the Code provides special rules for treatment of income an exempt organization receives from a controlled entity.

Section 512(b)(13)(A) of the Code provides that notwithstanding sections 512(b)(1), (2) and (3) of the Code an organization (controlling organization) receiving a specified payment from another entity which it controls (controlled entity) shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the

net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.

Section 512(b)(13)(C) of the Code provides that the term "specified payment" means any interest, annuity, royalty, or rent.

Section 512(b)(13)(D)(i) of the Code provides, in part, that the term "control" means in the case of a corporation, ownership (by vote or value) or more than 50 percent of the stock of such corporation, and in any other case (other than a corporation or a partnership) ownership of more than 50 percent of the beneficial interests in the entity.

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 513(c) of the Code provides that the term "trade or business" includes any activity that is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1 (a) of the regulations provides, in part, that unless one of the specific exceptions of section 512 or 513 of the Code applies, the gross income of an exempt organization subject to the section 511 tax is includible in the computation of unrelated business taxable income if, (1) it is income from a trade or business, (2) such trade or business is regularly carried on by the organization, and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(2) of the regulations provides, in part, that in determining whether a trade or business is "regularly carried on", regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends, in each case, upon the facts and circumstances involved.

In Better Business Bureau v. United States, 326 U.S. 279, 66 S. Ct. 112; 90 L. Ed. 67 (1945), 1945 C.B. 375, the Supreme Court when construing the meaning of the phrase "exclusively for educational purposes" stated, "this plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39, 63 S. Ct. 1132, 87 L.Ed. 1499, 1943 C.B. 1011 (1943), the Supreme Court ruled on the issue of whether a corporation was a separate taxable entity. It was reasoned by the court that a parent corporation and its subsidiary are separate taxable entities, as long as the purpose for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities.

In Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970), the court had to decide whether the business activities of each corporation to which plaintiff taxpayers had transferred partnership property were sufficient to require recognition of the corporations as separate taxable entities. The court considered the purpose for which the corporation was organized to determine if its bona fide intention was to have some real and substantial business function and reasoned that it did and thus its existence should not generally be disregarded for tax purposes.

In Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1106 (5th Cir. 1973) it was stated by the court that the control required for liability under the "instrumentality" rule is where there is total domination of the subsidiary to the extent the subsidiary manifests no separate corporate interests and functions solely to achieve the purpose of the dominant corporation.

Analysis:

You are an organization recognized as exempt under §501(c)(3). Any income you produce is exempt from federal income taxes if it is related to your exempt purpose. If an exempt organization receives income from a trade or business that is regularly carried on unrelated to its exempt purpose it is potentially subject to tax under §511.

B was formed as a separate legal entity. B will have its own activities and management apart from you. B's establishment as a for-profit corporation needs to be analyzed to determine whether its planned activities or its income will be attributed to you as the parent.

For federal income tax purposes, a parent corporation and its subsidiary are considered separate taxable entities, so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, where a corporation is organized with the bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt, supra at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1106 (5th Cir. 1973).

You represent that you formed B for the bona fide business purpose of licensing Software X to other educational institutions and commercial businesses in hopes of developing it into a viable commercial business. B will further develop Software X to enable you to run and track Program A. B's licensing of the use of Software X to other educational institutions will allow them to offer

similar competency-based programs. B will have a real and substantial business purpose. Therefore, its existence should not be disregarded for federal income tax purposes.

B will not be a mere instrumentality of you. B's Board of Directors will not consist of a majority of your Board members. A majority of B's directors will not be employed by you nor be on your Board of Directors or related to any person employed by any of your directors. You will not actively participate in the day-to-day affairs of B for you will only exercise your normal rights as a shareholder and as permitted in your Bylaws. You represent that B will maintain separate books and records including maintaining separate bank accounts and financial records. B will also maintain separate facilities and addresses apart from you, as well as telephone numbers and telephone listings. Also, to the extent B leases office space from you, then you will be reimbursed the fair market value of the usage. Likewise, to the extent you provide administrative services to B, you will receive reimbursement for the fair market value of your services.

Based on the facts and representations stated above, B should be treated as a separate entity for tax purposes. Thus, B's activities and income should not be attributed to you as the parent to adversely affect your tax-exempt status under §501(c)(3). Likewise, none of B's gross income should result in any unrelated business taxable income to you under §512(a)(1). B's activities and operations are conducted solely by B and are not attributed to you and therefore are not considered to be a trade or business that is "regularly carried on" by you. See Section 1.513-1(a); see also Section 1.513-1(c)(1).

Whether the dividends you may receive from B should be excluded from the computation of unrelated business taxable income under §512(a)(1) would depend on if the dividends are an allowable modification permitted in subsection (b) and not a specified payment within the meaning of subsection (c). In accordance with §512(b)(13), if a controlling entity receives or accrues a specified payment from another entity it controls then such payment is included in gross income as derived from an unrelated trade or business to the extent it reduces the net unrelated income of the controlled entity. For purposes of §512(b)(13), B would be considered a controlled entity, since you own more than 50 percent of the vote and value of B's stock. However, dividend income is not a specified payment. Inasmuch as B is a separate tax entity, any dividends you receive from B would be a modification under §512(b)(2). Accordingly, any dividend income that you may receive from B will not be subject to the unrelated business income tax.

Rulings:

- 1) Your ownership of B will not have an adverse effect on your tax-exempt status under §501(c)(3).
- 2) The gross income realized by B will not be treated as unrelated business taxable income to you under §512(a)(1).
- 3) Any dividends you may receive from B will be excluded under §512(b)(1) from the computation of unrelated business taxable income under §512(a)(1).

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto
Manager, EO Technical

Enclosure
Notice 437